From West to East

Weekly Investment View

29th July, 2018

There is some hype, but stocks remain a great investment

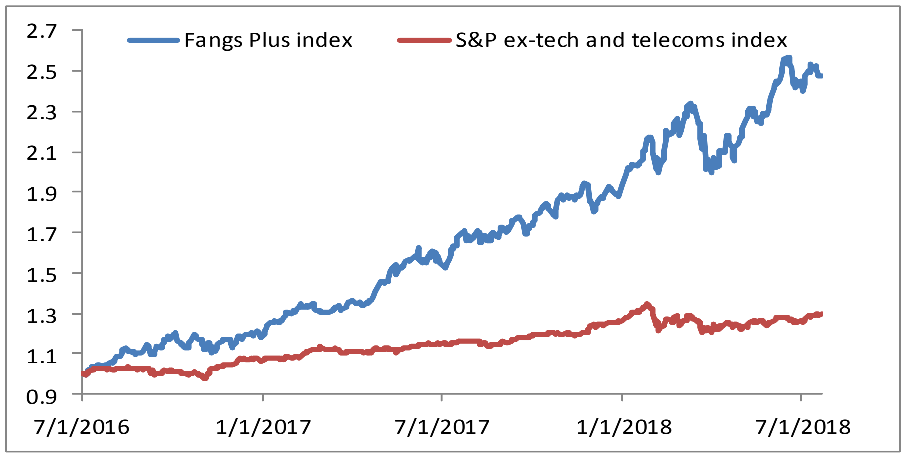
Last week may have reminded some investors of the rise and fall of tech stocks in the late 1990s, as Facebook became the unhappy holder of the record for worst one-day market cap loss in the history of American stocks. Netflix, Facebook and Twitter lost a combined US$133.38 billion in market cap the day after they reported earnings.

However, this time things are different. Sure, analysts looking at some of the trendiest tech stocks may have gotten a little bit ahead of themselves and had a reality check in the past two weeks. In no way, though, should investors shy away from tech stocks. It is just a matter of seeing where there is value, and where expectations remain realistic. Facebook, for one, has 2.5 billion users, almost as many as those estimated to use the internet in the world, so there is a limit to its future growth. Similar ideas can be applied to Netflix and Twitter. Unlike the companies in the dotcom bubble, though, these are viable businesses, with real, tangible revenues and in many cases decent cash flow. They are not going anywhere — it is just a matter of adjusting expectations. The FAB Asset Allocation Committee (AAC) had already identified that some of the specific technology valuations needed calibration. However, the AAC has continued to be bullish on the technology sector overall.

In a meeting last week, the Committee decided to maintain that position with a caveat to be careful of overhyped companies and their valuations. The reasoning is simple: technology is the main driver for future gains in the US economy, especially as it reaches full employment.

There is no denying the way technology has reshaped people's lives in the past 20 years. And given the direction it is going, it will continue to do so for the next 20. Not being a part of that as an investor would mean missing many of the most promising stories.

Technology goes beyond social media



Source: Bloomberg; S&P Indices. Indexed to July 2016 for comparability.

and the biggest gains are being made with little fanfare. The 'cloud' has enabled people to have a computer in their pockets (most applications on your Apple or Android cellphone run on decentralized networks and servers, commonly referred to as the cloud). The devices carried in pockets and purses, while more powerful than anything ever dreamed of 30 years ago, do not have the memory to carry and process all the information used in their apps. Cloud computing makes that possible.

Blockchain, also a form of decentralized computing, is revolutionizing financial services and supply chains. While the most known use for the distributed ledger (the geek name for blockchain) is bitcoin, companies ranging from insurers to banks have started to use it to reduce human error, accelerate the speed of transactions and reduce the number of checks necessary to execute a contract. As with anything related to technology, there is a lot of hype. Look beyond that, and there is real value in the tech sector.

"The risk for technology is that trendy names overshadow promising, albeit less-known, companies in the sector."

Perception, however, matters. The worse-than-expected results of the largest names in technology had a negative effect on US stock markets, which otherwise have every reason to continue to rally and hit new records. On Friday, the US Bureau of Economic Analysis said the world's largest economy grew at a 4.1% annual rate in the second quarter, the fastest rate since 2014. That came as unemployment is near its lowest in 40 years. These economic tailwinds were among the reasons why the FAB AAC remains bullish on US stocks even as key indices approach record highs. Indeed, so far, 86% of the companies that have announced quarterly earnings in the US have beaten estimates. Earnings growth has been above 20% on average for listed companies.

The AAC, however, has been worried about the effects of an escalating trade war. Hence, members discussed increasing exposure to companies focused on domestic US consumption. As US growth accelerates and wages continue to increase, more Americans will buy new products, cars and homes. The companies that provide those services to 330 million Americans are likely to do well, trade war or not..

That however, has been missed by many. Homebuilders, for one, benefit heavily from a strong economy, but are among the worst performers in the S&P 1500 year-to-date. The industry sub-index dropped 18.4% year-to-date, compared to a positive 6.5% return for the broader index and a 56.6% return for IT and direct marketing, the index leader. This has also made homebuilding one of the cheapest industries in the S&P 1500, at only 11 times trailing earnings.

That move seems to have been largely driven by the notion that rising rates have a negative impact on the sector. However, statistics suggest interest rates are not the key driver for homebuilders. Historically, home sales and prices have driven returns in the industry. These two factors are influenced much more by unemployment and wages than by interest rates.

In fact, home prices have yet to catch up with wage gains since the 2008 crisis. The National Association of Realtors' Affordability index is currently at 151 (where higher is more affordable). The historic median is 130, meaning the index needs wages to drop 15% or home prices to rise by that much to revert to its mean. Furthermore, since 2010 more than 19 million people were added to the age bracket normally associated with homeowners, according to US Census Bureau data. Home sales are also far from their peak and, at 689,000 in June, below their 20-year average of 718,000.

"US homebuilder stocks have dropped because of rising rates, but the sector could benefit as more Americans need homes and wages rise."

The US is the world's largest economy, with GDP of US$20 trillion. Therefore, what happens to America matters to the world. However, China is the second biggest, with GDP projected to reach US$13.5 trillion this year, and it may still grow twice as fast as the US. In some areas, such as commodities — metals in particular —, China is already more important than the US.

China accounted for 42% of global copper consumption in 2016, twice the share it commanded 10 years earlier. China's use of the red metal rose to 10.5 million tons from 3.5 million in these 10 years.

Copper leads other metals, so what happens in China matters to those commodities. Last Monday, Beijing announced tax cuts and special bonds for infrastructure investment to counter any expected economic slowdown stemming from a trade war with the US. The measures spurred a rally in Chinese stocks, led by construction and infrastructure names.

Similarly, Asian high-yield bonds rallied on the back of this news as investors understood that Chinese developers — which comprise about a third of the asset class — would benefit from the re-leveraging of the economy and the renewed focus on construction.

The move should not come as a surprise. The main driver of the Chinese economy is exports. The second most important factor is construction. The trade war with the US threatens to reduce China's exports, so Beijing has to boost construction to keep the economy humming.

"The trade war may increase demand for metals as China uses construction to boost economic growth."

That is good news for emerging countries, many of which export the commodities that will be in higher demand if China fires on all cylinders in construction. However, it will not be a free-for-all. Soft commodities, such as cotton and soybeans, may suffer more as Beijing adds tariffs to imports from the US, leaving American farmers to flood other markets and potentially depress global prices.

The key driver for emerging market stocks and currencies this year, however, have been a firmer US dollar and rising interest rates. While the dollar index failed to breach the key 95.00 level, it finished last week 0.2% higher at 94.669. Meanwhile, the yield on 10-year US Treasuries rose six basis points to 2.95% on Friday, amid speculation the Bank of Japan could tighten monetary policy and after fresh signs of US economic strength.

The strong dollar and rising US rates mean money is still exiting emerging markets, devaluing their currencies and therefore boosting inflation. One of the poster-children for that has been Turkey. The lira has devalued 21.7% this year as President Recep Tayyip Erdogan nudged the central bank to be accommodative even as inflation hit 15.4% in June. The currency lost 3% last Tuesday alone after the central bank failed to raise interest rates, contrary to expectations.

Elsewhere, Pakistan saw the voting-in of a new prime-minister last week. Imran Khan's Pakistan Tehreek-e-Insaf Party won the most seats in Parliament after a campaign in which the former cricket star promised to stamp out corruption. Otherwise, Khan has promised to follow a pragmatic agenda. He has, for one, vowed an attempt to rekindle relations with India, something which, if delivered, could have major positive repercussions for the region.

Egypt, meanwhile, is moving forward with a key plan to privatize its state-owned companies. Public Enterprise Minister Hisham Tawfik said in an interview last week that the country plans to go ahead with offering shares in a developer and a tobacco company. The move would line Cairo's coffers but also promises more efficiency as multiple academic studies of the privatizations in Latin America have shown that the process improved profit margins by an average of 50%, while improving services to the population.

INVESTMENT SUMMARY: The FAB AAC last week decided not to change its major weightings. The Committee debated, however, whether there was further room for the long economic cycle to run, and whether it was time to reconsider its overweight position in equities. Ultimately, the AAC concluded that tax cuts and regulatory changes in the US are likely to boost earnings for American companies for a few years, helping support global markets as well.

SMALL TALK: A US study has found that companies which have CEOs who spend a lot of time golfing tend to show worse financial performance over time.

For any inquiries related to this article, please contact:

Alain.Marckus@bankfab.com;

Christofer.Langner@bankfab.com

From West to East

Weekly Investment View

29th July, 2018

Disclaimer:

This report has been prepared and issued by Products & Services - Elite & Private Banking ("P&S-EPB") of First Abu Dhabi Bank PJSC ("FAB") outlining particular services provided by P&S-EPB and does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to purchase or subscribe for, any shares in FAB or otherwise or a recommendation for a particular person to enter into any transaction or to adopt any strategy nor shall it or any part of it form the basis of or be relied on in connection with any contract therefore. This report is incomplete without reference to, and should be viewed solely in conjunction with the associated oral briefing provided by P&S-EPB. The report is proprietary to P&S-EPB and may not be disclosed to any third party or used for any other purpose without the prior written consent of P&S-EPB. The information in this report reflects prevailing conditions and our views as of this date, which are accordingly subject to change. In preparing this report, we have relied upon and assumed, without independent verification, the accuracy and completeness of all the information available from public sources or which was otherwise reviewed by us. In addition, our analysis are not and do not purport to be appraisals of the assets, stock or business of the recipient. Even when this presentation contains a kind of appraisal, it should be considered preliminary, suitable only for the purpose described herein and not be disclosed or otherwise used without the prior written consent of P&S-EPB. FAB clients may already hold positions in the assets subject to this report and may accordingly benefit from the buying or selling of such assets as referred to in this report. This document does not purport to set out any advice, recommendation or representation on the suitability of any investment, transaction or product (as referred to in this document or otherwise), for potential purchasers. Potential purchasers should determine for themselves the relevance of the information contained in this document and the decision to purchase any investment contained herein should be based on such investigation and analysis as they themselves deem necessary. Before entering into any transaction potential purchasers should ensure that they fully understand the potential risks and rewards of that transaction (including, without limitation, all financial, legal, regulatory, tax and accounting consequences of entering into the transaction and an understanding as to how the transaction will perform under changing conditions) and that they independently determine that the transaction is appropriate for them given their objectives, experience, financial and operational resources and other relevant circumstances. Potential purchasers should consider consulting with such advisers and experts as they deem necessary to assist them in making these determinations and should not rely on FAB for such purposes. FAB is acting solely in the capacity of a potential arm's-length contractual counterparty and not as a financial adviser or fiduciary in any transaction unless we have otherwise expressly agreed so to act in writing. FAB does not provide any accounting, tax, regulatory or legal advice. FAB is licensed by the Central Bank of the UAE.

London: *FAB London Branch is Authorized by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from FAB London branch on request. Registered in England & Wales: Company No: FC009142: VAT No: GB245 3301 91.*

Paris: *FAB Paris Branch is licensed by the French Prudential Control Authority as a credit institution. FAB Paris is registered in France under the company number: RCS Paris B 314 939 547.*

Switzerland: *This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness. All information and opinions as well as any prices indicated are currently as of the date of this report, and are subject to change without notice. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. At any time the First Abu Dhabi Bank PJSC and/or FAB Private Bank (Suisse) SA may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. First Abu Dhabi Bank PJSC expressly prohibits the distribution and transfer of this document to third parties for any reason. First Abu Dhabi Bank PJSC and/or FAB Private Bank (Suisse) SA will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law. The "Directives on the Independence of Financial Research", issued by the Board of Directors of the Swiss Bankers Association (SBA) do not apply.*

Singapore: *First Abu Dhabi Bank P.J.S.C., Singapore Branch is regulated by the Monetary Authority of Singapore and holds a Wholesale Bank license.*